Focus on the ESG change when scoring sovereigns

FRANKLIN TEMPLETON

At Franklin Templeton, one of our best examples of integrating environmental, social and governance (ESG) factors in macroeconomic research comes from the Templeton Global Macro team. The most important distinction in their approach comes from a forward-looking view. A good deal of the sovereign ESG work out there takes a backward view, assessing just where a country stands today and where it's been, but not necessarily where it's headed–and the pace of change. Our rigorous proprietary ESG scoring system, the Templeton Global Macro ESG Index (TGM-ESGI) covers 56 countries and it is a composite of 13 subcategories determined to be material to macroeconomic performance.

Getting a bit specific

TGM-ESGI as a tool reflects the belief that ESG can be successfully utilized by investors in the sovereign space when:

1. Fully integrated into the other components of research, including traditional economic analysis and on-the-ground visits. These issues contribute to core macroeconomic views on a country. ESG factors are then expressed through analysis of economic issues such as growth and inflation.

2. Focused on forward-looking data points. Rather than current ESG performance, which is strongly correlated with income levels, we believe that momentum, or change in score, is the measure that truly matters for both potential investment performance and for determining where capital could be deployed for the greatest positive impact (see Exhibit 1)

3. Deployed as a tool for **identifying investment opportunities** in addition to highlighting **areas of risk**. Our team is most interested in the "tails" signaling major ESG shifts in either direction.

4. Calibrated with long time horizon. ESG factors guide a country's fundamentals, which can be overshadowed in the short term by cyclical or temporary conditions. We believe conviction in the view and patience to see that view come to fruition are requisites to successful ESG investing.

The research team assigns numbers by overlaying their views on a benchmark created by global indexes for current scores. Analysts then provide projected numbers in anticipation of how conditions will change in the medium term. The final scores are calculated with weightings of 40% for governance, 40% for social and 20% for environment. The environment receives a lower weighting because its effects on macroeconomic performance take place over a significantly longer-term time horizon. The change in score, the metric TGM places the greatest emphasis on, is simply the projected score minus the current score.

Watch the tails

In piecing the puzzle together, they pay greatest attention to the "tail" countries in which there is a drastic change with regards to projected ESG scores in either direction. An example of improving ESG projected scores can be found in Brazil.

The business climate in Brazil is expected to improve significantly with reduced red tape and corruption, along with the administration's push for the privatization of state-owned enterprises and reduction of trade barriers. We are also cautious of potential deterioration in certain ESG factors due to the current administration's inclinations, paying particular attention to institutional strength, social cohesion and unsustainable practices.

In our latest update we expand on six countries, find the latest Templeton Global Macro ESG Index (TGM-ESGI) update at **www.ftinstitutionalemea.com/globalmacroesg**

Exhibit 1: Templeton Global Macro ESG Index Scores: Projected Change.

Projected changes represent the difference between current ESG scores and future ESG scores. As of February 2019